Client Update
The Tax Cuts and Jobs Act Conference Report

On December 15, 2017, key leaders of the Republican Party in Congress reached an agreement on legislative language (the "Conference Report") for fundamental tax reform. This follows weeks of negotiations reconciling proposals made by the Senate (the "Senate Bill") and the House of Representatives (the "House Bill"), both of which are described in our prior client updates. The Conference Report upends many fundamental and long-standing principles of the U.S. income tax system including **by eliminating most itemized deductions, limiting the deductibility of business interest expense, immediately reducing the corporate tax rate to 21%, adding a special deduction for business income earned by non-corporate taxpayers, introducing broad base erosion avoidance measures and changing the taxation of foreign earnings**.

Our summary below highlights the important aspects of the Conference Report. The Conference Report effects such a sweeping change in U.S. taxation that almost every business structure and transaction will have to be rethought in light of the new rules. The prospect for passage of the legislation appears to be virtually certain. Although the substantial reduction in business tax rates is certainly a commerce-friendly change, the Conference Report introduces many new complex provisions that will meaningfully affect taxpayers, and there will be winners and losers under the new regime.

Unless otherwise indicated, all changes are effective for tax years beginning after December 31, 2017. Most of the provisions relating to individuals expire after 2025.

INDIVIDUALS

Tax Brackets

- Seven individual income tax brackets will be retained, but the tax rates will be lowered and the income brackets to which they apply will be modified. The **top individual rate** will be reduced to 37% (down from 39.6%) and will apply to taxable income over $600,000 for joint filers ($300,000 for married individuals filing separately and $500,000 for any other individual).

Comment: The top 37% rate is lower than either of the top rates proposed by the House or the Senate. Unlike the House and Senate Bills, the Conference Report implies a "marriage penalty."

Alternative Minimum Tax

- The **individual alternative minimum tax** will be retained but the exemption amount will increase to $109,400 for joint filers ($54,700 for married individuals filing separately and $70,300 for any other individual) and the exemption amount phase-out threshold will increase to $1 million for joint filers ($500,000 for any other individual).

Comment: Retention of the individual AMT was a surprise as it was slated for elimination in both the House and Senate Bills. The AMT is complex and unpopular.

Capital Gains

- There will be no changes to current rates for **capital gains, dividends and interest income**.

Carried Interest

- The beneficial treatment of **carried interest** will only be retained for investments that meet a three-year holding period requirement. This treatment allows long-term capital gains to flow through to the owners of these interests, including in connection with a sale of the interests, if the holding period is met.

Itemized Deductions

- Most itemized deductions will be eliminated. The **standard deduction** will almost double, and personal exemptions will be repealed. Charitable donations will remain deductible.

State and Local Tax Deduction

- The deduction for all **state and local taxes** (other than non-income taxes incurred in a trade or business) will be capped at $10,000.

Comment: The limitation on the deduction for all state and local taxes will disproportionately affect taxpayers living in jurisdictions with high state and local tax rates (*e.g.*, New York, New Jersey, Connecticut and California).

Comment: The Conference explanation clarifies that business income taxes imposed on pass-through entities **will not** be subject to this limitation.

Mortgage Interest Deduction

- The limit on loan size for the **mortgage interest deduction** will be lowered from $1 million to $750,000 for houses financed after December 15, 2017. Consistent with the Senate and the House Bills, the deduction for home equity indebtedness will be repealed.

Estate and Gift Tax

- The **estate and gift tax** exemption amount will be doubled to $10 million. The basis step-up upon death will remain.

  Comment: In the House Bill, the estate tax would have been eliminated after 2024.

BUSINESSES

Tax Rates: Corporations

- The top corporate tax rate will be reduced permanently to **21% beginning in 2018**. Corresponding changes to the dividends received deduction will be made to reflect the reduction in the corporate rate from 35% to 21%.
- The corporate alternative minimum tax will be repealed.

Tax Rates: Pass-Through Entities

- The Conference Report creates a **20% deduction for tax years from 2018 through 2025 for qualified business income** received by taxpayers, including trusts and estates, from pass-through entities (partnerships, LLCs or S corporations) or proprietorships. The deduction generally cannot exceed the greater of the pass-through owner's share of (i) 50% of the pass-through business's W-2 wages and (ii) 25% of the pass-through business's W-2 wages plus 2.5% of the tax basis of business's tangible depreciable property. The deduction also applies to ordinary dividends received from a **REIT**.

  Comment: The deduction generally does not apply to income received from a personal service business (such as a law firm, accounting firm, investment advisory business or consulting firm). Taxpayers with taxable income below $157,500 (or $315,000 for a joint return) are permitted to claim the full 20% deduction for qualified business income, without regard to the limitation for W-2 wage income (and, if applicable, tangible property), even if derived from a personal service business.

  Comment: Employees earning a salary or bonus from pass-through entities (as opposed to owners) are not eligible for the deduction. The provision may therefore favor operating as an independent contractor/proprietor versus an employee. Partnerships may consider converting employees to partners to allow them to benefit from the deduction.

Tax Deductions: Depreciable Property

- **New business investments** in qualified depreciable property (not including structures, intangible assets or property used in certain public utility businesses) acquired from an unrelated party by purchase after September 27, 2017 may be **expensed** (written off entirely in the year of acquisition). This favorable provision is to stay in place for **five years** (or six

years for certain property with a longer production period), with a phase down of 20% per year thereafter (i.e., 80% depreciation in 2023, 60% in 2024 and so forth).

Comment: The Conference Report adopts the House Bill approach and allows immediate expensing of both **new property and used property—**the Senate Bill would have applied only to new property. M&A buyers will be incentivized to purchase assets or businesses in flow-through form during this period so that they can immediately expense the cost of depreciable property.

Tax Deductions: Interest Expense

- The deduction for **net interest expense** (business interest expense less business interest income) will be **limited** to 30% of a business's adjusted taxable income. Any disallowed amounts will be **carried forward indefinitely**. The limitation does not apply to certain **real estate businesses** that elect out of the rule or to a business with average gross receipts of $25 million or less.

Comment: The Senate Bill defined adjusted taxable income narrowly by not adding back depreciation and amortization. The Conference Report compromises by adjusting taxable income by depreciation and amortization **(*i.e.*, EBITDA)** for taxable years beginning before 2022. The amount of deductible interest for taxpayers that own significant depreciable or amortizable tangible or intangible property may be substantially reduced beginning in 2022.

Comment: For partnerships, the limitation will be determined at the partnership level. Special rules will allow a pass-through business's unused limitation to be used by its owners. However, any net interest expense of a partnership that is subject to the limitation and carried forward by a partner may only be used against subsequent adjusted taxable income from that partnership.

Tax Deductions: Net Operating Losses

- **Net operating losses** will generally be carried forward indefinitely and generally may not be carried back (as opposed to current law which allows carryback for two years and carryforward for 20 years). A net operating loss carryforward may **offset only 80% of taxable income**.

Tax Credits

- **Most business tax credits are preserved** with no change from current law. The conference Report modifies the rehabilitation credit and the orphan drug credit, and adds a new temporary credit for wages paid to qualifying employees during a period that such employees are on family and medical leave.

Like-Kind Exchanges

- The Conference Report eliminates the ability to engage in a tax-free **like-kind exchange** of any property other than real property, with grandfathering rules for exchanges that are in progress in 2017.

Private Activity Bonds

- The Conference Report did **not** adopt the House Bill's elimination of the exemption for interest on private activity bonds. The exemption for interest on **private activity bonds** is retained.

Unrelated Business Taxable Income

- Tax-exempt organizations that are subject to tax on **UBTI** may not **apply losses or deductions against income** if they arose from different unrelated trades or businesses.

  Comment: The Conference Report did **not** adopt the House Bill's proposal to subject certain tax-exempt state and local entities, including **state and local pension plans**, to tax on **UBTI**.

Gain on Partnership Sales

- Gain recognized by a foreign person on the sale of an interest in a partnership engaged in business in the U.S. is treated as ECI on a "look-through" basis (*i.e.*, by reference to the character of gain that would have been recognized if the partnership had instead sold all its assets).

  Comment: This provision is designed to reverse a recent Tax Court decision (in the *Grecian Magnesite Mining* case) which held that a foreign investor did not have to pay U.S. federal income tax on gain recognized on the sale of an interest in a partnership engaged in a U.S. business.

INTERNATIONAL

Territorial System

- Prospectively, the U.S. will adopt a "**territorial system**," under which the U.S. will **allow a deduction** for dividends received by a U.S. corporation from a 10% or greater owned foreign subsidiary to the extent attributable to foreign source income. A one-year holding period is required, and the 10% shareholder's basis in the foreign subsidiary is adjusted to avoid taking artificial losses.
  - A "**hybrid dividend**" rule **denies** this deduction to the extent the foreign payor of a dividend is allowed a tax benefit in its home jurisdiction in connection with the payment, even if the tax benefit cannot be used by the payor or the benefit is of negligible value.

Comment: Many tax structures include instruments that could generate hybrid dividends (*e.g.*, preferred equity certificates issued by a Luxembourg holding company).

One-Time Tax on Repatriated Foreign Earnings

- To transition to the new "territorial" system, 10% or greater U.S. shareholders of controlled foreign corporations ("CFCs") and foreign corporations with a 10% or greater corporate U.S. shareholder ("specified foreign corporations"), will be required to pay a **one-time tax** on all existing foreign earnings (other than earnings accumulated prior to the foreign corporation becoming a specified foreign corporation). Foreign earnings held in illiquid assets will be taxed at **8%**, and cash equivalents will be taxed at **15.5%**, which are higher rates than those in either the Senate Bill or House Bill. Payment of the resulting tax liability can be spread over eight years in increasing installments.

Comment: The one-time tax is likely to be burdensome for minority U.S. shareholders that will need U.S. tax information from foreign entities that normally do not report such information.

Comment: The Conference Report also includes a "recapture" rule under which a U.S. shareholder that subsequently engages in a **tax inversion** within 10 years will lose the benefit of the preferential tax rate (*i.e.*, the one-time tax will be at a **35% rate**). This will disincentivize future inversions.

Comment: The earnings subject to the one-time tax are limited to those generated when a foreign corporation was a specified foreign corporation. It is not clear how this limitation is intended to interact with the changes to the CFC attribution rules.

Base Erosion Taxes

- The Conference Report imposes a **5% minimum tax** rate in 2018 on U.S. corporations' taxable income determined without regard to deductions for "base erosion" payments to foreign affiliates (including interest and purchases of depreciable assets, but excluding certain derivative payments and payments to the extent subject to U.S. withholding tax). This tax rises to **10%** in 2019 and increases again to **12.5%** after 2025. The minimum tax will apply to a corporation where at least 3% of its deductions qualify as "base erosion" payments (2% if the affiliated group includes a bank). Companies that engaged in a **tax inversion** after November 9, 2017 must also treat the cost of goods imported from related foreign affiliates as a "base erosion" payment.
    - Related-party reinsurance payments are treated as "base erosion" payments for this purpose.
    - Affiliated groups with a bank or securities dealer as a member will be subject to an increased minimum tax rate of 11%. There is an exception for S corporations.

Comment: These provisions sharply reduce the tax benefit derived from making deductible payments to foreign affiliates and could impose a significant economic burden on **U.S. insurance companies** that reinsure business to offshore affiliates.

Comment: Because the provision operates as a minimum tax (similar to the AMT), some U.S. corporations **will** be able to continue to use some base erosion strategies to reduce taxable income subject to the regular 21% rate.

Tax on Profitable Foreign Subsidiaries/Intangible Income

- U.S. shareholders of a CFC will be taxed on the CFC's net active income in excess of a "routine" return of **10%** on the CFC's investment in depreciable **tangible property**.
    - The Conference Report defines the base for the tax as "global intangible low-taxed income," or the subtle acronym "**GILTI**." GILTI is treated in the same manner as Subpart F income, meaning that it will be taxed currently. Shareholders of a CFC with a high proportion of intangible assets will be most exposed to the tax because intangible assets are not part of the 10% routine return base.
    - GILTI is effectively taxed at **10.5%** until **2025** and then effectively taxed at **13.125%** thereafter. Generally, a foreign tax credit at **80%** may be applied against the GILTI tax. The Conference Report also incentivizes keeping intangible assets in the U.S. by effectively applying lower tax rates on a U.S. corporation's "foreign-derived intangible income" or "**FDII**" (income earned by the **U.S. corporation** from selling property or providing services to foreigners in excess of a "routine" return of 10% on the corporation's investment in depreciable tangible property). FDII enjoys an effective lower tax rate of **13.125%** until **2025** and **16.406%** thereafter. The GILTI tax rates are equal to 80% of the FDII rates and reflect that GILTI may be subject to foreign taxes, only 80% of which are creditable against the GILTI tax.
    - In determining the routine return of 10%, certain interest expense will now be subtracted from gross income derived from depreciable tangible property, which may produce a higher amount of GILTI.

Comment: The Conference Report is targeted at CFCs that generate income from **intangible assets** (regardless of whether those assets were migrated from the U.S. or actually created offshore). However, it will also apply to income from successful operating businesses that generate high returns on tangible assets.

Comment: The Conference Report discourages the migration of assets and personnel to foreign jurisdictions by subjecting "excess returns" to U.S. tax on a current basis. Given a U.S. rate of just 21%, the costs (including a few percentage points of foreign tax rates) of operating offshore and the new U.S. tax on excess offshore returns, U.S. companies will question whether a migration is worth the trouble.

Limitations on Interest Deductibility

- The Conference Report departs from both the House Bill and Senate Bill and does not include a limit on the deductibility of interest of U.S. corporations with foreign affiliates.
- Consistent with the Senate Bill, U.S. payors are denied a deduction for interest or royalties paid to a related party in a **hybrid transaction** where the payments are not included in income (or are deductible) under the recipient jurisdiction's tax law or to a related **hybrid entity** (entities that are fiscally transparent under U.S. law but not fiscally transparent under foreign tax law, or vice versa).

  Comment: The hybrid limitation may disrupt existing investment fund "blocker" structures capitalized in part with debt.

Controlled Foreign Corporation (CFC) Rules

- **U.S. shareholders** owning 10% or more of the **value** (as opposed to just **voting power** under current law) of a foreign corporation's stock will count towards the CFC ownership test and may be required to have CFC income inclusions. The scope of the CFC rules will be dramatically expanded (for **2017** and subsequent years) so that **almost all** foreign corporations in a multinational group that includes a U.S. entity will be treated as CFCs. Unlike the Senate Bill and House Bill, however, the Conference Report does not eliminate the "Section 956" rules that tax U.S. shareholders on the CFC's investments in U.S. property.

  Comment: These provisions will impose an additional tax burden on 10% U.S. owners of CFCs. Voting cutback provisions, which are common for foreign insurance companies, will no longer be sufficient to avoid CFC status.

  Comment: Companies that have adopted structures designed to avoid the CFC rules (such as certain "inverted" groups) will either be forced to restructure or pay tax on certain offshore earnings.

INSURANCE COMPANIES

Income Tax Rates

- Regular corporate income tax rates, *i.e.*, 21%, will apply to insurance companies beginning in 2018. The Conference Report does not include the surtax on life insurance companies that was put into the House Bill as a placeholder.

Deferred Acquisition Costs

- DAC rates will increase to 2.09% for annuity contracts, 2.45% for group contracts and 9.20% for all other contracts. The DAC amortization period will be extended from 10 years to 15 years.

  Comment: The change will result in a negative cash tax effect, as insurers will have more upfront taxable income in exchange for deductions spread over 15 years. The

increase in the amortization period reduces the present value of the deferred deductions and may have a negative effect on the admissibility of deferred tax assets on statutory financial statements. However, the provisions are substantially more favorable to insurers than the original Senate Bill, which included a 50-year amortization period.

Deduction for Life Tax Reserves

- 92.81% of a life insurance company's statutory reserves are deductible, based on the reserve methodology effective at the time the reserve is measured. Changes to tax reserves will be phased in over eight years.

Deduction for P&C Unpaid Losses

- Property and casualty companies' deduction for unpaid losses will be reduced. P&C companies generally will discount unpaid losses using less favorable discount rates and less favorable payment assumptions. Changes to unpaid losses will be phased in over eight years.

  Comment: The changes will have the effect of accelerating taxable income for P&C companies.

Dividends Received Deduction ("DRD")

- Life insurance companies will be able to claim 70% of the DRD for their investment income. The adjustment to a P&C insurance company's taxable income to add back a portion of the DRD, tax-exempt interest and the cash value of insurance will be increased from 15% to 25%.

  Comment: Unlike the change to unpaid losses, this change creates a permanent tax difference for P&C companies. P&C companies with large allocations to tax-exempt bonds will be particularly affected. The effect of the change on a life insurance company will need to be evaluated on a case-by-case basis.

Net Operating Losses ("NOLs")

- The special loss carryover rules for life insurers will be repealed. Regular NOL carryover rules (including the repeal of carrybacks) will apply instead. P&C companies will continue to retain their special loss carryover rules.

  Comment: Life insurance companies are particularly affected by the changes to carryover rules, as the current law carryback period is longer than that of regular corporations, and under Statement of Statutory Principles No. 101, it is easier to admit a tax asset for a carryback than for a carryforward.

Passive Foreign Investment Company ("PFIC") Rules

- The Conference Report establishes a bright line test for foreign insurance companies that rely on the active insurance business exception to the PFIC rules. To qualify for the exception, an insurance company must have "applicable insurance liabilities" (measured by

loss and loss adjustment expenses and life and health reserves) that exceed 25% of its total assets.

Comment: The exclusion of unearned premiums from the definition of applicable insurance liabilities could pose difficulties for catastrophe and other property and casualty reinsurers, regardless of how active they are. Insurance companies should also consider the treatment of forms of reinsurance transactions that do not transfer reserves.

COMPENSATION

Deferred Compensation

- There are no provisions which prevent deferral of certain compensation.
- **Comment:** This is welcome news to employers and employees alike. The House Bill originally included a rule under which it would no longer be possible to defer certain compensation, but was amended to remove these provisions. The provision then crept into the original Senate Bill but was removed in last-minute negotiations in committee.

Compensation Deduction Limitation

- The Conference Report provides that the **$1 million** deduction limitation under Section 162(m) **that applies to public companies** will be expanded to deny a deduction to **more** companies for **more** compensation payable to a **larger** group of employees. The Conference Report includes a **transition rule** that will exempt from the proposed changes any compensation that is paid pursuant to a **written binding contract in effect on November 2, 2017** that was not modified after this date in any material respect.

Comment: Performance-based compensation, including equity awards, will no longer be exempt from the 162(m) deduction limitation. This is likely to have a significant impact on how public companies compensate their top executives.

Comment: The "covered employees" to whom the deduction limitation will apply include the CEO and the CFO (in each case, whether or not serving as executive officers as of the end of the year) and the next three most highly compensated executive officers. In addition, once considered a "covered employee" for a given year, the individual will be treated as a "covered employee" for all subsequent years.

Comment: The employers subject to the 162(m) deduction will be expanded to include **Section 15(d) filers** (*i.e.*, companies that issued equity or debt securities to the public in a registered public offering, but have not listed on a securities exchange, such as foreign private issuers and debt issuers).

Comment: The transition rule will apply to many forms of outstanding performance-based equity awards and long-term cash awards, as well as other non-discretionary compensation arrangements that were in place as of November 2, 2017.

However, the IRS may assert that commonly used "162(m)" plans that permit the compensation committee to **reduce** the amounts payable upon the attainment of performance goals (*i.e.,* plans that permit the committee to exercise so-called "negative discretion") are not considered "binding" contracts for purpose of the transition rule. Companies should consider taking actions (such as fixing by board or committee action the 2017 bonus pool amount or eliminating post-2017 service requirements) to accelerate the deduction for bonuses under such "162(m)" plans into 2017 in order to utilize the performance-based compensation exception during 2017 and to take advantage of the higher deduction rate for 2017.

Excess Tax-Exempt Organization Executive Compensation

A new **21% excise tax** on "excessive compensation" payable by **tax-exempt organizations** will be imposed on compensation payable to each of the five highest-paid employees ("covered employees") to the extent such compensation exceeds $1 million in any year and on severance payments to any such individual to the extent the severance payments exceed the average of the individual's last five years of compensation. Once considered a "covered employee" for a given year, the individual will be treated as a "covered employee" for all subsequent years. The Conference Report has an additional provision that compensation paid to a doctor or veterinarian that is directly related to medical or veterinary services performed by the doctor or veterinarian is not taken into account for purposes of the excise tax.

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Please do not hesitate to contact us with any questions.

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